No. 16037

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

T. F. KORHERR,

Appellant,

vs.

A. J. BUMB, Trustee in Bankruptcy of Mallard Pond Builders, Inc., Bankrupt,

Appellee.

APPELLANT'S OPENING BRIEF.

EDGAR C. KELLER,
302 Katz Building,
San Bernardino, California,
Attorney for Appellant.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

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Appellee.

APPELLANT'S OPENING BRIEF.

Statement of Pleadings and Facts as to Jurisdiction.

Mallard Pond Builder's, Inc., a California Corporation, was adjudicated a bankrupt upon a Petition filed March 13, 1957, in the United States District Court, Southern District of California, Central Division. The matter was assigned Bankruptcy No. 76443-PH. Appellee A. J. Bumb was appointed trustee of the estate of the bankrupt and caused to be served upon Appellant T. F. Korherr, Hansen-Sargent Lumber Company, and Perpetual Savings & Loan Association (hereinafter referred to as "Perpetual") an Order to Show Cause why certain funds held in a construction loan account by Perpetual should not be turned over to the trustee. Appellant and Hansen-Sargent filed Answers to the trustee's Petition upon which the Order to Show Cause had been based, and issue was thereby joined. Following a stipulation of facts

and oral and written arguments, the Referee filed a written Referee's Decision and subsequently there were entered his Findings of Fact and Conclusions of Law and "Judgment as to Stop Notices," whereby he ruled in favor of Hansen-Sargent as against the trustee, but in favor of the trustee as against Appellant.

Appellant filed a Petition for Review in the aforementioned District Court, but the United States District Judge, Alexander Bicks, by order entered April 3, 1958, adopted the report of the Referee. Notice of Appeal was filed by Appellant on May 1, 1958.

A more detailed statement of the proceedings has been made a part of the agreed statement and may be found at pages 24 *et seq.* of the Transcript of Record.

Jurisdiction of the Court of Appeals exists under the provisions of Sections 47 and 48 of Title 11 of the United States Code Annotated.

Statement of the Case.

The factual background of this controversy is set forth as part of the agreed statement [Rep. Tr. p. 21 *et seq.*], as well as in the Findings of Fact [Rep. Tr. p. 7 *et seq.*]. It may be briefly summarized as follows:

The bankrupt entered into a series of construction loan agreements of a standard type with First Federal Savings and Loan Association of Beverly Hills, subsequently known as Perpetual Savings & Loan Association. A copy of one of the agreements has been made a part of the record. Simultaneously with the execution of the loan agreements, the bankrupt executed standard notes and deeds of trust covering the lots which were to be the sites of the construction to be financed by the loan agreements. Thereafter, the bankrupt did commence construc-

tion of houses and garages on the lots for which loans had been obtained. In accordance with the loan agreements, however, the proceeds of the loans were not disbursed except as progress payments in accordance with the agreed schedules.

Appellant, a licensed flooring contractor, furnished labor and materials for the flooring of houses on the aforementioned lots. This was done pursuant to a contract made directly with the bankrupt, as there was no general or prime contractor save in the sense that the bankrupt served as its own general contractor. The bankrupt entered into numerous individual contracts with plumbing contractors, flooring contractors, electrical contractors, sheet metal contractors, etc., and materialmen similar to that into which it entered with Appellant. The bankrupt did employ one Stan Schmidt, the holder of a general contractor's license, to supervise all construction, and it designated him as its responsible managing employee.

Appellant was paid only in part for the flooring which he furnished and installed. Pursuant to Section 1190.1 (h) of the California Code of Civil Procedure, therefore, he filed with Perpetual a so-called "stop notice" requesting the withholding of further payments to the bankrupt in a sum sufficient to pay Appellant's bill. This stop notice was filed within the time required by law and prior to the adjudication in bankruptcy. It was accompanied by a bond as set forth in said Section 1190.1(h). Also pursuant to the Code of Civil Procedure, and prior to the adjudication in bankruptcy, Appellant duly and properly filed an action in the California Courts on the stop notice.

At the time that Appellant served his stop notice on Perpetual, Perpetual held funds in the construction loan

accounts in an amount sufficient to satisfy all stop notice claims, namely those of Appellant and Hansen-Sargent.

As heretofore mentioned, this controversy arose out of an Order to Show Cause based on the Trustee's Petition alleging that the construction loan funds constituted an asset of the bankrupt's estate. Appellant and Hansen-Sargent claimed that to the extent necessary to satisfy their stop notices, the funds in the construction loan accounts were theirs and not assets of the estate. The Referee upheld the contention of Hansen-Sargent, holding its stop notice to have been valid, but held that Appellant's stop notice was ineffectual on the ground that Appellant was a contractor within the meaning of the exclusionary provisions of Code of Civil Procedure, Section 1190.1(h) and therefore not entitled to avail himself of the stop notice remedy. This ruling was adopted by the District Court.

There is no argument as to the facts. The primary question on appeal relates to whether the Referee's interpretation of Code of Civil Procedure, Section 1190.1(h), as adopted by the District Court, is correct. Specifically, the question is this: May a flooring contractor who contracts directly with an owner-builder to furnish labor and materials for flooring, on a project on which the owner-builder does not have a general contractor, avail himself of the stop notice remedy provided by California Code of Civil Procedure, Section 1190.1(h), as to construction loan funds?

Specification of Errors.

Appellant specifies as error the following conclusion of the Referee, set forth as Conclusion 2 [Rep. Tr. p. 14] and as item 2 of the Judgment [Rep. Tr. p. 17] as follows:

> "2. That the claimant, T. F. Korherr is a contractor and therefore not entitled to avail himself of the Stop Notice remedy. That therefore the Stop Notice of said claimant is invalid and imposes no claim or lien upon the building loan funds paid over to the Trustee by the lending institution, Perpetual Savings and Loan Association of Beverly Hills."

Appellant submits that he is not a contractor within the meaning of the exclusionary provision of Code of Civil Procedure, Section 1190.1(h), and therefore the Referee and the District Court erred in concluding, determining, and holding, as set forth above, as follows:

(1) That Appellant was a contractor.

(2) That no contractor is entitled to avail himself of the stop notice remedy.

(3) That Appellant was a contractor within the meaning of Code of Civil Procedure, Section 1190.1(h).

(4) That Appellant's stop notice was invalid and imposed no claim upon the building loan fund.

(5) That Appellant had no claim upon the building loan fund.

With respect to (5) above, it is urged that such holding was error by reason of the provisions of the building loan agreement itself as well as under Code of Civil Procedure, Section 1190.1(h).

ARGUMENT.

I.

Historical Background of Stop Notices.

A Notice to withhold, or stop notice, is not identical with a mechanic's lien, but rather a cumulative remedy. (*Weldon v. Superior Court* (1903), 138 Cal. 427, 71 Pac. 502.) Nevertheless, its purpose is to supplement the mechanic's lien remedy and the stop notice law is inextricably intertwined with mechanic's lien law. It is thus desirable to consider something of the history of both mechanic's liens and stop notices in order properly to interpret Code of Civil Procedure, Section 1190.1(h). Mechanic's liens have always been favored in California law. The right to a mechanic's lien is guaranteed by the constitution. (*Cal. Const.,* Art. XX, Sec. 15.) This has been interpreted as a mandate to the legislature to protect this special class of persons—those who furnish labor and materials in building construction. In addition to the claim of lien against property, those so furnishing labor and materials have had for many years the right to serve upon the owner of property for the improvement of which the labor or materials were furnished a notice directing the owner to withhold from the payments to the general contractor a sufficient amount to cover the claim of the one serving the notice.

However, the courts and the legislature stripped the bare mechanic's lien of much of its value by taking from it the priority which it would have normally possessed over construction loan trust deeds. This was done by granting priority to construction loan trust deeds recorded before the commencement of work even though funds had not yet been advanced. (See *Cal. Code Civ. Proc.,* Secs. 1188.1 and 1189.1.) At the same time, be-

cause of the change in business customs, stop notices served upon owners on private construction had become ineffectual. Lending institutions, in order to control the loan funds, had generally commenced using loan agreements with provisions similar to those contained in the contracts in the case at bar [Ex. A] as follows:

> "The net proceeds of this loan (as the term 'net proceeds' is defined in the Borrower's Instructions executed in connection with this loan), upon recordation of the Deed of Trust, are to be placed on deposit with the Association, together with the sum of $*none* to be deposited by the undersigned owner, in a special non-interest-bearing account entitled 'LOANS IN PROCESS-BUILDING LOAN ACCOUNT,' and the undersigned agree that the deposit of said sums in said account shall be conclusively deemed a full and complete consideration for said note and Deed of Trust and that such consideration shall be deemed to have been fully passed and paid to the undersigned owner. Such funds are to be paid out, and are to be used, for the purposes set out herein. Subject to the provisions of this agreement, the undersigned, and each of them, hereby irrevocably assign to the Association, as security for the obligations secured by said Deed of Trust and the due performance of this agreement by the undersigned or any of them, and for any other joint and/or several obligation or obligations of the undersigned or any of them to the Association, all of the right, title and interest of the undersigned or any of them in and to said account and all monies to be placed therein, specifically including amounts that may be deposited in said account from time to time in the future either by the undersigned or by the Association. The undersigned acknowledge that they, or any of them, have no right to the monies in said account other than to

> have the same disbursed by the Association in accordance with this agreement, which disbursements the Association, upon its acceptance of this agreement herein, agrees to make, for the purpose, and upon the conditions set out herein. . . .
>
> "The undersigned, and each of them, agree that all funds received hereunder are received in trust for the purpose of paying in full all contractors and/or materialmen and/or laborers (other than the undersigned) then or theretofore engaged in said construction, and that the undersigned shall not have any beneficial interest in said funds unless and until said purpose has been fulfilled."

Under such an agreement, the owner of the property (who is the borrower) has no control over the funds, and a stop notice served upon him is valueless.

In order to carry out the spirit of the Constitution and replace in some manner that protection to those who had furnished labor and materials for construction which had been lost by the change in business customs and law above referred to, in 1951 the legislature passed those measures which are now found in Code of Civil Procedure, Section 1190.1(h) to (m) inclusive. These Sections provide for the filing of a stop notice with a party holding the construction loan funds, requesting that sufficient funds to be withheld to pay the claimant. This Section further provides that the holder of the funds may so withhold funds to answer such claims, but is obligated to do so only if the claimant files an appropriate bond undertaking to reimburse "the owner, contractor, or person holding such funds" for all damages that may be sustained by reason of such "equitable garnishment."

Although this provision was first enacted in 1951, it had its roots in certain judicial rulings prior thereto. The

first of these was *Smith v. Anglo-Californian Trust Company* (1928), 205 Cal. 496, 271 Pac. 898. In that case there was a dispute between the administratrix of Smith, the owner-builder, and certain lien claimants as to who was entitled to the undisbursed balance of the construction loan fund. There was nothing in the loan agreement that obligated the lending institution to see that the money was paid to the lien claimants. The court held, however, that the borrower had induced the materialmen and subcontractors to part with their labor and materials in the belief that the loan funds would be used to pay their bills and that the borrower was therefore estopped to deny the right of the subcontractors and materialmen to have the funds so applied.

In *Pacific Ready-cut Homes v. Title Insurance Trust Company* (1932), 216 Cal. 447, 14 P. 2d 510, the Supreme Court referred to the *Smith* case as having been decided upon the dual grounds of estoppel and that the lien claimants had an "equitable lien" on the funds. In *Whiting-Mead Company v. Westcoast Bond and Mortgage Company* (1944), 66 Cal. App. 2d 460, 152 P. 2d 629, the court held in a similar situation that it was the duty of the trustee to pay the funds to those who helped build the building.

It may be assumed that the aforementioned legislation of 1951 was enacted in the light of these and similar cases with a view to giving legislative sanction to the principles that had been judicially established, as well as to settle certain questions of priorities that had arisen. (See *Hayward Lumber Company v. Coast Federal Savings and Loan Association* (1941), 47 Cal. App. 2d 211), and to provide a definite procedure for the perfecting of claims against construction loan funds.

II.

The Legislative Intent of Section 1190.1 Requires Sustaining Appellant's Stop Notice Right.

The primary rule of statutory construction is that the intention of the legislature, if ascertainable, must be given effect.

> *Union Iron Works v. IAC* (1922), 190 Cal. 33, 210 Pac. 410;
>
> *United States v. Dodson* (1920), 268 Fed. 397.

The language of a statute should never be so construed as to nullify the intention of the legislature.

> *Chambers v. Satterlee* (1871), 40 Cal. 497, 524.

Code of Civil Procedure, Section 1190.1(h), commences as follows:

> "Any of the persons mentioned in Sections 1181 and 1184.1, *except the contractor* at any time prior to the expiration of the period within which claims of lien must be filed for record, . . . (may file a notice to withhold)". (Emphasis added.)

The Referee and District Court held that Appellant "is a contractor and therefore not entitled to avail himself of the Stop Notice remedy" [Rep. Tr. pp. 14-17]. The Appellee has heretofore conceded in the briefs filed with the District Court that sub-contractors are entitled to the remedy of the stop notice. In any event, that question has already been settled by the Ninth Circuit Court of Appeals. (*Welles v. Portuguese-American Bank* (1914), 211 Fed. 561.) But, the Referee's ruling implies, the Appellant made his contract to furnish flooring directly with the owner-builder, and, therefore, is a contractor rather than a sub-contractor. And, the Referee's ruling further implies, all contractors are precluded from filing stop

notices by the exclusionary phrase above quoted. Apparently there was no doubt in the minds of the Referee and District Court that Appellant would have been entitled to serve a stop notice if there had been a general contract or if the general contractor had been someone other than the owner of the real property. The ruling of the lower court would thus permit flooring contractors, plumbing contractors, painting contractors, etc., to file stop notices where an intervening general contractor is involved but not where the owner himself lets out the contracts to the flooring, plumbing, and painting contractors. No purpose is served by such a distinction.

The Legislative intent in enacting Code of Civil Procedure, Section 1190.1(h) to (m) was undoubtedly to enable the furnishing of labor and materials in reliance on a security interest in the construction loan funds. Under the ordinary construction loan agreements, the general contractor is entitled to progress payments as various phases of the construction are completed. The fulfillment of the Legislature's intention requires that anyone—be he a laborer, a materialman, a flooring contractor, or otherwise—who is entitled to be paid by the general contractor, but who has not been so paid, may file a stop notice with the construction lender setting forth the fact that the general contractor has failed to pay him and requesting the lender to withhold from the general contractor to the stop notice claimant. In that manner, the claimant may perfect his security interest in the loan funds. It is completely immaterial to the purposes of this section whether a flooring contractor was an "original contractor." To hold that he, as well as every plumbing contractor, painting contractor, plastering contractor, roofing contractor, electrical contractor, etc., is barred from

filing a stop notice against construction loan funds wherever an owner-builder acts as general contractor would be to deprive the sub-contractor of his stop notice remedy in a majority of cases and to emasculate the salutary remedy provided by the law.

III.

The Phraseology of Code of Civil Procedure, Section 1190.1(h) Requires Sustaining Appellant's Stop Notice Right.

It will be recalled that the Code Section in question commences, as follows:

> "Any of the persons mentioned in Sections 1181 and 1184.1, except *the* contractor . . . (may file a notice to withhold)" (Emphasis added.)

Section 1181 refers to

> "mechanic's, materialmen, contractors, sub-contractors, artisans, architects, machinists, builders, teamsters, and draymen, and all persons and laborers of every class performing labor upon or bestowing skill or other necessary service upon, or furnishing materials to be used or consumed in . . ."

Section 1184.1 refers to those who grade or pave streets or install sewers.

Appellant submits that the use of the words, "except *the* contractor," makes it obvious that only one contractor on each job was to be excluded, namely the general or prime contractor. That the word, "contractor" is here used in the sense of a general contractor is further indicated by the subsequent reference in the second paragraph of the same sub-section to the payment from the bond of costs awarded against "the owner, contractor, or person holding such funds" and damages that such "owner, con-

tractor, or person holding such funds may sustain by reason of the equitable garnishment effected by the claim . . .". Again at the end of said sub-section, it is stated that

> "No assignment by the owner *or contractor* of construction loan funds, whether made before a verified claim is filed, or after such claim is filed, shall be held to take priority over claims filed under this subsection (h) . . ." (Emphasis added.)

It is obvious that throughout this sub-section "the contractor" is bracketed with the owner and the "person holding the construction loan funds" because he—the general contractor—is the person to whom the lending agency normally pays the progress payments. Obviously he can derive no beneficial interest from a stop notice directing the withholding of payments to himself until he has been paid by himself, other than to confuse the lending agency as to the total amount of legitimate stop notices. Therefore, the Legislature mentioned that he was excluded from the remedy.

The Legislature did not exclude "a contractor," nor did it exclude "the contractors." It excluded "the contractor." The use of the specific article "the" together with the singular "contractor," should be interpreted to mean just what it says—one contractor on a job, the prime contractor, the same one that is subsequently given the right to recover on the claimant's bond if he has been damaged by a stop notice.

It is well recognized that mechanic's lien statutes are remedial and to be liberally construed to effect their salutary purpose. (*Gallagher v. Compondonicio* (1931), 121 Cal. App. Supp. 765. Words of exception to a law

are to be strictly construed to limit the exception, particularly where the law itself is one entitled to a liberal construction.

Piedmont and N. R. Company v. ICC, 286 U. S. 299, 76 L. Ed. 1115, 52 S. Ct. 541;

United States v. Scharton, 285 U. S. 518, 76 L. Ed. 917, 51 S. Ct. 416;

Dean v. McMullen, 109 Ohio St. 309, 142 N. E. 683.

IV.

If There Be Ambiguity in the Phraseology of Code of Civil Procedure, Section 1190.1(h), the Construction Loan Agreements Resolve Same.

The construction loan agreements specifically provide [Ex. A, Par. 7]:

> "The undersigned, and each of them, agree that all funds received hereunder are received in trust for the purpose of paying in full all contractors and/or materialmen and/or laborers (other than the undersigned) then or theretofore engaged in said construction, and that the undersigned shall not have any beneficial interest unless and until said purpose has been fulfilled."

This agreement was written in the light of the law, legislative and judicial, above referred to. As a standard provision in such agreements, it is indicative of the interpretation placed on the code by the lending institutions and contractors who deal with these matters regularly.

Moreover, the parties specifically and expressly placed the construction loan funds in trust for Appellant and his fellow contractors, materialmen, and laborers, and provided that the bankrupt should have *no* interest therein

until the contractors, materialmen, and laborers were paid. Under these provisions, it is unnecessary for Appellant to rely on Code of Civil Procedure, Section 1190.1(h), as he is a third party beneficiary of the agreement and the beneficiary of the trust thereby created. The Appellee, as successor to the bankrupt, can have no beneficial interest in said funds until Appellant has been paid.

Conclusion.

As the complete effectuating of the salutary remedy intended by the Legislature requires a construction which would permit all contractors other than the prime contractor on a job to file stop notices, and as Appellant was the beneficiary of the construction loan funds both by the terms of the law and the terms of the construction loan agreement, it is submitted that the order and judgment appealed from should be reversed.

Respectfully submitted,

Edgar C. Keller,

Attorney for Appellant.